



## OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan  
*County Executive*

Bruce Romer  
*Chief Administrative Officer*

May 20, 2003

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended March 31, 2003. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

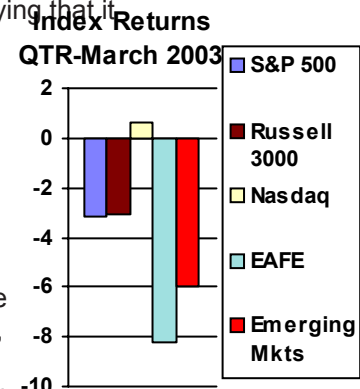
### History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,989 active members and 4,115 retirees participating in the System as of June 30, 2002.

### Capital Markets and Economic Conditions

Economic news released during the first quarter was generally disappointing. Auto sales fell, core retail sales stayed soft, and even the booming housing sector showed signs of weakness. These drags have pulled the economy to the verge of recession. Consensus estimates of GDP growth for the first half of 2003 approached 2% by the end of March. In addition, evidence of declining inflation continued to accumulate, with the 12 month change in core CPI running at just 1.3% during February, down from 2% just nine months prior. The Federal Reserve met on March 18 and left rates unchanged, but gave no bias, implying that it believed geopolitical uncertainty and higher energy prices were temporarily holding the economy back. The forecast looks for a removal of the first quarter drags and a healthy boost from policy to help the economy avert recession. Consumer spending should begin to improve, with help from lower energy prices, richer sales incentives on autos, and the resolution of war uncertainties.

While most equity markets reported positive results in March, results for the quarter were negative (see chart to the right). The broad U.S. markets were down around 3%, international markets, as represented by the EAFE Index, were down a combined 8%, with the largest markets in Europe and Japan down 8 to 9%. Small company stocks had the strongest performance during the quarter, especially internet stocks.



# QUARTERLY REPORT

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It is easy to blame the war for the soft global economy, but the root of the problem is that global growth remains driven by U.S. household spending. Investors are keeping a close eye on indicators of household spending, the most important being mortgage rates, earnings growth and the job market. Corporate hesitation in taking on new workers is just one example of the reluctance to expand while profitability remains under pressure and the business environment remains uncertain. Of the 230 S&P 500 companies that have released first-quarter statements, three-quarters have issued profit warnings. With firms struggling to meet investors' profit forecasts, capital investment remains a low priority. During the last quarter, our domestic equity performance improved significantly as we outperformed the benchmark index by over 40 basis points. The System's combined domestic equity performance for the quarter was a loss of 2.6 percent, outperforming our benchmark index loss of 3.0 percent. Internationally, equities continue to struggle with many of the same problems facing the U.S. including weak consumer spending growth. Our combined international equity performance was a loss of 7.0 percent, outperforming our benchmark loss of 7.3 percent. For the one year ending March 31, the international equity investments outperformed the benchmark by over 200 basis points.

Within the fixed income sector, record-setting demand for high yield securities resulted in the best quarterly performance for the asset class in nearly eight years, over 8%. Given the low yielding alternative of core fixed income and stubbornly high equity valuations, pension funds, institutional managers and insurance companies continue to allocate capital to the high yield sector. High Yield mutual funds experience inflows of \$9.9 billion during the quarter compared to \$6 billion for all of 2002 as investors continued to look for "equity-like" returns. Our combined fixed income performance was 2.6 percent for the quarter, slightly behind our benchmark index return of 2.8 percent. For the one year ended March 31, our combined fixed income performance is 70 basis points behind the index.

The total return achieved by the Employees' Retirement System's assets for the quarter was a loss of 1.28 percent compared to the System's benchmark target return loss of 1.65 percent. For the one year period ending March 31, the System's total return is 150 basis points above the benchmark target. The System's asset allocation at March 31, 2003 was: Domestic Equities 47.5%, International Equities 14.1%, Fixed Income 32.5%, TIPS 5.3%, Cash .1% and Real Estate .5%. Fiscal year-to-date performance was a loss of 5.94% compared to the System's policy benchmark loss of 6.61%.

## **Additions**

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending March 31, 2003 and Fiscal Year to date.

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### **Employees' Retirement System Contributions and Investment Income (millions)**

	<b><u>Qtr 3/31/03</u></b>	<b><u>Fiscal YTD</u></b>
Employer Contributions	\$ 13.9	\$ 41.3
Member Contributions	3.6	11.1
Net Investment Loss	(21.4)	(102.7)
	\$ (3.9)	\$(50.3)

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## ***Deductions***

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

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### **Employees' Retirement System Deductions by Type (millions)**

	<b><u>QTR 3/31/03</u></b>	<b><u>Fiscal YTD</u></b>
Benefits	\$27.2	\$75.3
Refunds	.1	.5
Administrative Expenses	<u>.5</u>	<u>1.5</u>
	<b>\$27.8</b>	<b>\$77.3</b>

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## ***Outlook***

There is little question that geopolitical worries are currently depressing economic activity. Business managers recognize that developments in Iraq have important implications for medium-term profit outlook, and most believe that a resolution will be achieved quickly. Accordingly, there are very strong incentives for businesses to delay hiring and capital spending decisions until after the conflict in Iraq is resolved. The economy continues to face major headwinds from poor profit fundamentals in the corporate sector and looming financial imbalances in the household sector.

## ***Major Initiatives***

During the last quarter, the Board approved the hiring of a large capitalization growth manager who will be funded by assets currently invested in an index fund. The Board received its first capital call, \$1,200,000, for the private equity fund-of-funds investment. In addition, the Board approved amendments to the bylaws.

# QUARTERLY REPORT

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## EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

March 31, 2003

### Assets

Equity in County's pooled cash and investments	<u>\$568,534</u>
Investments	
Northern Trust	1,763,288,949
Aetna	8,154,000
Fidelity - Elected Officials Plan	547,589
Fidelity - Deferred Retirement Option Plan	<u>424,181</u>
Total investments	<u>1,772,414,719</u>
Contributions receivable	4,311,980
Fixed assets, at cost:	
Office equipment	111,375
Less: accumulated depreciation	<u>111,375</u>
Net fixed assets	<u>-</u>
Total assets	<u>1,777,295,233</u>

### Liabilities

Benefits payable and other liabilities	<u>227,485,684</u>
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<b>Net assets held in trust for pension benefits</b>	<b><u>\$1,549,809,549</u></b>
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## EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF CHANGES IN PLAN NET ASSETS March 31, 2003

<b>Additions</b>	<b>Quarter</b>	<b>Fiscal YTD</b>
Contributions		
Employer	\$13,885,758	\$41,286,778
Members	<u>3,594,033</u>	<u>11,141,071</u>
Total contributions	<u>17,479,791</u>	<u>52,427,849</u>
Investment Loss	(20,078,344)	(98,937,151)
Less investment expenses	<u>1,256,597</u>	<u>3,829,042</u>
Net investment loss	<u>(21,334,941)</u>	<u>(102,766,193)</u>
Total deletions	<u>(3,855,150)</u>	<u>(50,338,344)</u>
<b>Deductions</b>		
Retiree benefits	21,172,920	57,752,935
Disability benefits	4,740,000	13,950,000
Survivor benefits	1,257,000	3,621,000
Refunds		111,348
500,882		
Administrative expenses	<u>494,678</u>	<u>1,547,408</u>
Total deductions	<u>27,775,946</u>	<u>77,372,225</u>
<b>Net increase (decrease)</b>	<u>(31,631,096)</u>	<u>(127,710,569)</u>
<b>Net assets held in trust for pension benefits</b>		
Beginning of period	<u>1,581,440,645</u>	<u>1,677,520,118</u>
End of period	<u><b>\$1,549,809,549</b></u>	<u><b>\$1,549,809,549</b></u>